Nos. 9781 and 9782

In the United States Circuit Court of Appeals for the Ninth Circuit

WILSON BROTHERS & COMPANY (WILSON BROS. & CO.), A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum opinion of the Board of Tax Appeals (R. 31–67) is unreported.

JURISDICTION

The Board entered its decisions on August 6, 1940 (R. 68, 231–232) finding deficiencies as follows:

Year	Normal Income Tax	Additional Tax under Section 104 of the 1932 Act, and Section 102 of the 1934 Act	Penalty
1932	None	$3,316.84	$165.84
1933	$1,499.93	14,224.80	786.24
1934	1,912.05	9,740.70	582.63

The case is brought to this Court by the taxpayer's petitions for review filed October 31, 1940 (R. 69–82, 232–245), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. Is there substantial evidence to support the Board's conclusion that the Commissioner was justified (under Section 23 (k) of the Revenue Act of 1934) in refusing to permit deductions for the year 1934 on account of debts alleged to have become partially worthless in that year?

2. Did the Board properly determine the basis for depreciation purposes (under Sections 113 (a) (2), 113 (a) (8), 113 (b), and 114 (a) of the Revenue Acts of 1932 and 1934) of property acquired by taxpayer corporation by gift or acquired by its stockholders by gift and contributed by them to its capital?

3. Is there substantial evidence to support the finding of the Board that in the years 1932 to 1934, inclusive, the taxpayer was availed of to avoid the imposition of surtaxes upon its shareholders and therefore was subject to Section 104 of the 1932 Act and Section 102 of the 1934 Act, providing for additions to normal taxes under such circumstances?

4. Is there substantial evidence to support the finding of the Board that part of the deficiency for each of the years 1932 to 1934, inclusive, was due to negligence and therefore that the deficiencies for those years were subject to penalties as provided for in Section 293 (a) of the Revenue Acts of 1932 and 1934?

5. Is there any error in the arrangement of the Board's memorandum opinion which discusses separately each of the issues presented, grouping together a recitation of the facts and of the reasoning and conclusions with respect to each issue? The applicable statute is Section 1117 (b) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations are set forth as follows: Those pertaining to the first issue in Appendix A, *infra,* pp. 34–36; those pertaining to the second issue in Appendix B, *infra,* pp. 37–39; those pertaining to the third issue in Appendix C, *infra,* pp. 40–49; those pertaining to the fourth issue in Appendix D, *infra,* p. 50; and those pertaining to the fifth issue in Appendix E, *infra,* p. 51.

STATEMENT

The facts have been partially stipulated. (R. 23–30.) The record also contains oral testimony and exhibits. (R. 86–193.) This recitation of those facts which are pertinent to the issues on appeal will follow in general the arrangement used by the Board of Tax Appeals in its memorandum opinion; that is, certain general facts will be stated first, following which particular facts will be discussed as they pertain to each of the issues on appeal.

Two petitions were filed with the Board of Tax Appeals seeking a redetermination of the normal taxes, additional taxes and negligence penalties asserted by the Commissioner against taxpayer, Wilson

Brothers & Company, a corporation, for the years 1932, 1933 and 1934. (R. 31.) On January 31, 1927, F. A. Wilson and W. T. Wilson formed a partnership under the name of Wilson Brothers & Company, which continued to do business under that name until the taxpayer corporation was formed and took over that business in January, 1929. (R. 32–33.) Taxpayer corporation was organized under Nevada law, with an authorized capital stock of 200,000 shares of a par value of $25 each. Twenty shares were initially purchased by F. A. Wilson for $500 and twenty shares were initially purchased by W. T. Wilson for $500. No other shares have ever been issued. During the years in question the books of taxpayer corporation were kept on the accrual basis. (R. 33.)

(a) *With respect to first issue.*

In its return for 1934, taxpayer took a deduction of $5,000 on account of indebtedness due it from Woodhead Lumber Co. of California which was alleged to be partially worthless in the year 1934. The total debt due it from Woodhead Lumber Co. of California at the beginning of the year was $43,276.06. This debt was secured by collateral consisting of a note of another corporation (Woodhead Lumber Co. of Nevada) for $25,000 and stock of the other corporation having a face value of $37,000. Though there was testimony that the collateral had little or no value, taxpayer continued to do business with Woodhead Lumber Co. of Nevada. The Board concluded that the taxpayer had failed to show that the debt due from Woodhead Lumber Co. of California had become worthless in the indicated amount, and found no error in the Commissioner's disallowance of the $5,000 deduction claimed. (R. 37–38.)

In its return for 1934, the taxpayer deducted $5,500 on account of a debt alleged to be partially worthless in that amount represented by bonds of Kentucky Fuel & Gas Corporation. The bonds were a first mortgage upon the property of the company, which was an operating company with considerable assets. It went into receivership about 1931. The Board concluded that the record did not give sufficient particulars concerning the acquisition of the bonds or their cost to furnish a basis for the deduction sought and also found that there was nothing to show that the alleged worthlessness had not occurred in a prior year. It pointed out that the bid prices for the bond declined from $74 in 1930 to $5 in 1931, $2 in 1933 and $4.50 in 1934. The Commissioner's disallowance of the deduction was sustained. (R. 40–41.)

The steamship Idaho was constructed under a contract with Henry Wilson, the Charles R. Wilson Estate, Inc., and A. B. Johnson. Though the record is somewhat confused upon the point, the Board determined that the original ownership shares were as follows: Henry Wilson 65/100, Charles R. Wilson Estate, Inc., 25/100 and A. B. Johnson 10/100. (R. 41, 49–50.) The cost of the vessel was $200,000. It was completed about February 6, 1917, and its fair market value at that date was not less than $395,000. At that time Henry Wilson gave away the following shares in the vessel—to his wife, Mary Wilson, 20/100, to his son, W. T. Wilson, 5/100, and to his son, F. A. Wilson, 5/100. (R. 41–42.)

On June 6, 1924, Henry Wilson gave his wife the 35/100 interest which he then still owned. In July, 1925, F. A. Wilson and W. T. Wilson bought the 10/100 owned by A. B. Johnson (and wife) for $11,716.67. On January 2, 1929, Mary Wilson, W. T. Wilson and F. A. Wilson conveyed their interests in the Idaho (75/100 of it) to taxpayer corporation without consideration. (R. 42–43.)

The dispute upon this appeal is about the 20/100 interest given to Mary Wilson in 1917 and given by her to the corporation in 1929. The Board determined that it was acquired by the corporation by gift and that its basis in the corporation's hands was the same as the basis of the last preceding owner, who did not acquire it by gift, namely, Henry Wilson. Revenue Acts of 1932 and 1934, Section 113 (a) (2). The Board therefore took as the basis for this interest a pro rata part of the original cost of the vessel, rejecting taxpayer's contention that the basis should be a pro rata part of the value of the vessel at the date when this interest was given to Mary Wilson. (R. 50–51.)

(c) *With respect to third and fourth issues.*

Taxpayer was organized to engage in the business of logging, milling, transportation of and dealings in lumber and operation of steamships. (R. 55–56.) The steamships Oregon and Idaho were acquired in 1929, operated for six months and then laid up. They continued to be laid up through the taxable years 1932, 1933 and 1934, which are the years here in question.

(R. 56.) The taxpayer corporation was preceded by a partnership which had about $1,500,000 invested in its business of logging, lumbering, milling and shipping, and a similar business would have required about that much capital at the time of the hearing. (R. 56.) However, prior to 1932 taxpayer had ceased to carry on a logging, milling and shipping business. Though there was an intention to reenter that business at some time, it was not done during the tax years in question. During those years taxpayer engaged in a small lumber business and allied business. The logging and milling business was a losing business during those years. (R. 56.)

Other particulars of the taxpayer's business for the years in question are as follows (R. 56–57):

Year	Gross sales	Net losses from operations	Dividends from stocks	Undivided profits
1932	$28, 725. 96	$11, 740. 89	$18, 258. 00	$19, 309. 75
1933	92, 262. 09	1, 341. 36	17, 541. 00	36, 732. 00
1934	170, 239. 51	118. 75	25, 057. 00	[1] 60, 447. 64

[1] Consisting of $25,447.64 shown as undivided profits and $35,000 transferred to capital account. (R. 106, 154.)

The income tax returns filed by taxpayer show the common stock of taxpayer to have been the following amounts on the following dates (R. 57):

January 1, 1929	$696, 000
" 1, 1930	746, 000
" 1, 1931	800, 000
" 1, 1932	2, 500, 000
" 1, 1933	2, 500, 000
" 1, 1934	2, 500, 000
December 31, 1934	2, 535, 000

However, the only stock ever issued was that in the amount of $1,000 originally issued to W. T. Wilson and

F. A. Wilson. (R. 57.) Cash contributions were made to taxpayer by F. A. Wilson and W. T. Wilson from time to time. With such cash, taxpayer from time to time purchased stocks of domestic corporations. (R. 57.)

The income tax returns of the taxpayer show the following, among other things (R. 57–58):

	December 31		
	1932	1933	1934
Assets			
Cash	$1,106,377.07	$1,022,123.45	$972,147.49
Securities of Domestic Corporations	1,000,943.50	1,032,190.55	1,077,778.05
Liabilities			
Notes payable	200,000.00	----------	----------
Common stock	2,500,000.00	2,500,000.00	2,535,000.00

However the Board found that those items should have been as follows (R. 58):

	December 31		
	1932	1933	1934
Assets:			
Cash, as shown by Account Books and records	$96,638.23	$9,186.43	$73,707.36
Securities of Domestic Corporations as shown by Books of account and Record (cost)	750,943.50	782,190.55	837,778.05
Securities of Domestic Corporations as shown by Books of account and Record (market value)	439,961.87	777,792.00	810,797.75
Liabilities:			
Notes payable as shown by record	----------	----------	----------
Common stock per record	1,000.00	1,000.00	1,000.00

The taxpayer's records carried no item of $200,000 notes payable, though such an item appeared in the income tax returns, not only for the year 1932 as shown but also for the years 1929, 1930 and 1931. Taxpayer's records did not show that it possessed any I. O. U.'s. However, large amounts of I. O. U.'s were included in computing the cash on hand shown in the returns. These I. O. U.'s were given by W. T. Wilson and F. A. Wilson. At the time of the trial, the cash box contained an I. O. U. for $843,438.54 showing two equal items, one purportedly due from W. T. Wilson, the other from F. A. Wilson (R. 58–59.)

A certified public accountant was unable to take trial balances from taxpayer's general ledger at the beginning and end of 1932 and at the end of 1933 and 1934 because the general ledger accounts were incomplete. A balance was accomplished only after Francis Wilson, an officer, furnished the accountant with information concerning the identity of certain additional accounts. One of the items on the books dated January 31 (no year) was labeled "transfer from treasury stock $10,000". W. T. Wilson testified "we put in that much cash to take it up." The ledger of the corporation carried two accounts headed "treasury stock" totaling $250,000 but there was, in fact, no treasury stock. The corporate books did not indicate the years in which the recorded transactions occurred. (R. 50.)

No dividends or salaries to officers were paid by taxpayer between the date of its incorporation and the end of the last taxable year here involved. (R. 59.) No federal income taxes were paid by either W. T. Wilson or F. A. Wilson in the years 1932, 1933 or 1934, except about $150 paid by W. T. Wilson in 1932. (R. 59.)

Taxpayer's books show accounts receivable from F. A. Wilson as follows (R. 59–60):

Year	Charges	Credits	Net Due December 31
1933	$82, 597. 77	$39, 363. 40	$43, 234. 37
1934	62, 199. 38	69, 821. 25	35, 612. 50

On January 2, 1935, F. A. Wilson was credited with $35,612.50 by the purchasers of certain stock. The general ledger trial balance shows a different sum as of December 31, 1933, namely, $28,091.96. (R. 60.)

Accounts receivable from W. Wilson (presumably W. T. Wilson) are shown as $17,717.88, $16,917.88 and $16,917.88 at the ends of the years 1932, 1933 and 1934, respectively. (R. 60.)

The Board concluded that the record was unsatisfactory and often contradictory and that the corporate books were kept in no normal manner. (R. 60.) Primarily, taxpayer was a holding or investment company in the tax years in question, actual business operations being so few and far between that vouchers instead of a cashbook were used to record them. No dividends or salaries to officers were being paid. (R. 60–61.)

The sole stockholders contributed large sums of cash to taxpayer. The testimony of one of them was that such contributions amounted to nearly $1,300,000 though there is much contradiction in the record and that figure is not accepted by the Board. (R. 61–62.) W. T. Wilson testified to the following contributions of cash and other assets: December, 1928, $695,000; January 1, 1929, $50,000; January, 1930, $54,000; January 1, 1931, $480,000; and to the contribution of $1,700,000 in I. O. U.'s. He testified to a transfer of $35,000 from profit and loss to surplus and then from surplus to capital, though there was a net loss from operations. He explained an increase in cash on hand from $56,593.58 in December, 1930, to $1,642,298.24 in December, 1931, by saying "we just put a few I. O. U.'s in the cash box" and that I. O. U.'s were used right along. The two Wilsons for four consecutive years swore to income tax returns showing large amounts of cash which was really not cash at all but I. O. U.'s (R. 62.)

The same sworn statements for four consecutive years represented notes payable of $200,000 contrary to the facts, stocks of domestic corporations in the amount of $250,000 more than was the fact, and a capitalization of the taxpayer from $696,000 to $2,535,000 in excess of what it in fact was. (R. 62–63.) Thus, while no particular statement is worthy of consideration because of the many contradictions, it is apparent that the stockholders did contribute large amounts in cash and other assets with which stock and some bonds were purchased by the taxpayer. (R. 63.)

There was testimony by one witness that $1,500,000 would be needed to carry on in 1939 a business comparable to that carried on by the partnership prior to 1929, but there was no testimony pertaining to the requirements of such a business in the tax years in question, namely, 1932 to 1934. Whereas, the testimony indicates that some lumber business was carried on during those years, the large lumbering and milling business which the partnership had engaged in was not carried on and there was no showing that the accumulations from securities which were not distributed in the years in question were a business necessity. There was no showing of any intent to resume a business of the size formerly carried on by the partnership nor were any details given as to the real scope of the business which was expected to be undertaken. (R. 63–64.) The failure to make an adequate showing as to alleged future business needs was emphasized by the failure to show the business necessity for the large contributions of cash to the corporation which were invested in securities. The Board concluded that the taxpayer had not satisfied the burden of proving that earnings were not accumulated beyond business needs and that taxpayer was not availed of in the tax years to avoid surtaxes to its stockholders. (R. 65.)

The Board thought its conclusion strengthened by the credits permitted to stockholders which would not have been permitted if the accumulations were needed for business capital and by the fact that the corporation was used by the two stockholders, not wholly for legitimate business purposes, but as a sort of incorporated family pocketbook. (R. 65–66.)

The Board also concluded that taxpayer's method of keeping books and making returns was negligent. It determined that a part of the deficiency obviously was due to this negligence and imposed the 5 percent penalty. (R. 67.)

SUMMARY OF ARGUMENT

1. It is in the Commissioner's discretion to allow or not to allow a deduction for debts alleged to have become partially worthless in the tax year. When the Commissioner has refused to allow such a deduction the inquiry of the Court is limited to the question whether the Commissioner has abused his discretion, that is, whether he has acted arbitrarily and capriciously. An additional requisite for such a deduction is that the taxpayer must have ascertained that the portion of the debt claimed as a deduction became worthless in the tax year for which the deduction is sought. Whether the taxpayer did so ascertain is a question of fact as to which the finding of the Board of Tax Appeals is conclusive if supported by substantial evidence.

Taxpayer claimed that a $43,000 debt due it from Woodhead Lumber Company of California became worthless to the extent of $5,000 in the tax year. It is inherently improbable that the taxpayer could have ascertained with any degree of certainty that so small a part as one-ninth of the debt became worthless in the tax year. The only evidence to support its claim was the interested testimony of one of taxpayer's two stockholders, which was vague and contained an admission that there was substantial security behind the debt. As to bonds of Kentucky Fuel & Gas Corporation alleged to have been partially worthless in the tax year, there was no adequate showing of cost. Furthermore, the taxpayer's own evidence clearly discloses that

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the partial worthlessness alleged had occurred prior to the tax year.

Taxpayer did not sustain the burden of proving that either of these debts became worthless to the extent claimed in the tax year and did not show facts indicating that the Commissioner abused his discretion in refusing the deductions.

2. Taxpayer disputes the Board's determination as to the basis for depreciation purposes of a one-fifth interest in the steamship *Idaho* acquired by the taxpayer as a gift from the mother of its two shareholders or acquired by the shareholders as a gift from their mother and contributed by them to the taxpayer's capital. The mother had acquired this interest as a gift from her husband. Taxpayer claims that the basis in the corporation's hands should be the same as it was in the mother's, that is, it should be the fair market value of the property when given to the mother. However, the statute is clear that in the case of two consecutive gifts of the same property, the second donee is required to take the basis of the first donor. In the instant case, that means that the taxpayer's basis for the interest in question is the cost of that interest to the father of taxpayer's shareholders, as the Board found.

3. Taxpayer carried on a small lumber business in the tax years in question. It maintained during those years a very large balance of cash and securities. The income from those securities was not distributed to the two shareholders of taxpayer but was accumulated. That failure to distribute saved the shareholders some

surtaxes. The cash and securities held by taxpayer exceeded taxpayer's current needs for working capital. The explanation that taxpayer intended to greatly expand its business is given only by the interested testimony of one of taxpayer's two shareholders. This testimony was vague and, for adequate reasons advanced by the Board, hardly credible. There is substantial evidence to support the Board's conclusion that the taxpayer was primarily a holding or investment company, that its earnings were accumulated beyond its reasonable business needs, and that it was availed of to avoid the imposition of surtax upon its shareholders.

4. It is a reasonable inference from the record in the instant case that at least a part of the deductions claimed by the taxpayer in its returns and disallowed by the Board of Tax Appeals were claimed because of the carelessness of the taxpayer in keeping its records, making its returns, or studying the applicable statutes and Treasury Regulations. The Board was justified in finding that at least a part of the deficiency was due to negligence. Under the applicable statute, the penalty was properly imposed upon the entire amount of the deficiency.

5. The Board was not required to separate its findings of fact from its opinion. The arrangement of its memorandum opinion was a matter for its own discretion. The arrangement it chose was best calculated to promote a clear understanding of a lengthy and complicated case.

ARGUMENT

I

The Board correctly refused to upset the Commissioner's determination not to allow certain deductions claimed by the taxpayer in 1934 on account of debts alleged to be partially worthless

Section 23 (k) of the Revenue Act of 1934, Appendix A, *infra,* authorizes deductions for debts ascertained to be partially or wholly worthless and charged off accordingly. The allowance of a deduction for a partially worthless debt, as distinguished from a debt which is wholly worthless, is within the Commissioner's discretion. The statutory words are "and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt [illegible]

in an amount not in excess of t[illegible]

This means that if the Commiss[illegible] taxpayer's determination that a specific part of the debt has become worthless, the Commissioner's judgment is controlling. The Commissioner's decision may be upset by the courts only if it cannot be reasonably supported upon any theory, that is, only as it represents arbitrary and capricious action amounting to abuse of discretion. *Olympia Harbor Lumber Co.* v. *Commissioner,* 79 F. (2d) 394 (C. C. A. 9th); *United States* v. *Beckman,* 104 F. (2d) 260 (C. C. A. 3rd), certiorari denied *sub nom. Doty* v. *United States,* 308 U. S. 593; *Stranahan* v. *Commissioner,* 42 F. (2d) 729 (C. C. A. 6th), certiorari denied, 283 U. S. 822; *Commissioner* v. *Liberty Bank & Trust Co.,* 59 F. (2d) 320 (C. C. A. 6th); *Ross* v. *Commissioner,* 72 F. (2d) 122 (C. C. A. 7th); *Clark* v. *Commissioner,* 85 F. (2d) 622 (C. C. A. 3rd).

It has been held repeatedly that, as in the case of a deduction claimed for a wholly uncollectible debt, a deduction for part of a debt will be allowed only if it is shown that that part was ascertained to have become worthless in the taxable year for which deduction is sought. *American Sav. Bank & Trust Co.* v. *Burnet,* 45 F. (2d) 548 (C. C. A. 9th); *Pacific Nat. Bank* v. *Commissioner,* 91 F. (2d) 103, 105 (C. C. A. 9th); *Santa Monica Mountain Park Co.* v. *United States,* 20 F. Supp. 209, 211 (S. D. Cal.), affirmed, 99 F. (2d) 450 (C. C. A. 9th), certiorari granted and dismissed by stipulation of counsel, 306 U. S. 666; *Jones* v. *Commissioner,* 38 F. (2d) 550 (C. C. A. 7th); *Motter* v. *Wallace,* 72 F. (2d) 678 (C. C. A. 10th); *Austin* v. *Helvering,* 77 F. (2d) 373, 374 (App. D. C.); *Johnson, Drake & Piper* v. *Helvering,* 69 F. (2d) 151 (C. C. A. 8th), certiorari denied, 292 U. S. 650.[2]

We think that the same conclusion is compelled by the Treasury Regulations. Article 23 (k)–1 of Treas-

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[2] *Moock Electric Supply Co.* v. *Commissioner*, 41 B. T. A. 1209, quoted from by taxpayer (Br. 26), is not to the contrary. The quotation which taxpayer gives lacks this significant sentence which immediately follows it (p. 1212):

> Total worthlessness or disposition of the obligation remained open to this petitioner as a ground for deduction, notwithstanding the possibility that partial worthlessness may have appeared in an earlier year.

The rationale of the *Moock* opinion and of cases like *Blair* v. *Commissioner*, 91 F. (2d) 992 (C. C. A. 2d), which it cites, is that a taxpayer may wait until a debt is wholly uncollectible before taking any deduction. These cases do not hold that a debt which becomes uncollectible by 50 per cent in year A and is still uncollectible by that amount in year B may be deducted to the extent of 50 per cent in either year A or year B, as the taxpayer may choose.

ury Regulations 86, pertaining to the 1934 Act, Appendix A, *infra,* reads in part:

> Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible.

The same provision has appeared in all Treasury Regulations from 1921 to date.[3] It has come to have the force of law. *Helvering* v. *Wilshire Oil Co.,* 308 U. S. 90; *Helvering* v. *Winmill,* 305 U. S. 79, 83; *Morgan* v. *Commissioner,* 309 U. S. 78, 81.

If the law were otherwise, a taxpayer who had once ascertained that a debt was worthless in a given amount could take a deduction for that amount in any year thereafter when it best suited him, or, if he chose, could divide the worthless portion up into as many parts as was convenient and take a deduction for one part in each of several years. "The mind rebels against the notion that Congress * * * was willing to foster an opportunity for juggling so facile and so obvious." *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 330.

It may be observed also that the question "When did the taxpayer first ascertain the partial worthlessness claimed * * *?" is a question of fact. The burden is upon the taxpayer to show that it was ascertained in the year for which the deduction is claimed, and the

[3] Treasury Regulations 62, 1921 Act, Article 151; Treasury Regulations 65, 1924 Act, Article 151; Treasury Regulations 69, 1926 Act, Article 151; Treasury Regulations 74, 1928 Act, Article 191; Treasury Regulations 77, 1932 Act, Article 191; Treasury Regulations 94, 1936 Act, Article 23 (k)-1; Treasury Regulations 101, 1938 Act, Article 23 (k)-1; Treasury Regulations 103, Internal Revenue Code, Section 19.23 (k)-1.

determination of the Board upon the point must be sustained by the Circuit Court of Appeals, if supported by any substantial evidence. *Theatre Inv. Co.* v. *Commissioner,* 119 F. (2d) 477 (C. C. A. 9th); *Uhl Estate Co.* v. *Commissioner,* 116 F. (2d) 403, 405 (C. C. A. 9th); *Person Const. Co.* v. *Commissioner,* 116 F. (2d) 94, 95 (C. C. A. 7th); *Curtis* v. *Helvering,* 110 F. (2d) 1014 (C. C. A. 2d).

In the light of the foregoing analysis, it will be evident that there is no basis for reversal of the decision of the Board which affirmed the disallowance by the Commissioner of claimed deductions for partial worthlessness of the debt due the taxpayer from Woodhead Lumber Company and of the indebtedness represented by Kentucky Fuel & Gas Corporation bonds owned by the taxpayer. Both deductions were claimed in the year 1934.

At the beginning of 1934, taxpayer was owed about $43,000 by Woodhead Lumber Company, and has claimed partial worthlessness of only $5,000, or about one-ninth of the total debt. On its face, this claim would be more reasonable if it was for an addition to bad debt reserve. However, taxpayer admits that it does not have that character. Therefore, taxpayer has left itself with a very difficult burden of proof, that is, the burden of showing, as the applicable regulation (quoted *supra*) requires, that $5,000 may, with a reasonable degree of certainty, be said to be the amount by which this $43,000 debt became worthless in 1934.

The only testimony on that point was the interested testimony of W. T. Wilson, half owner of the taxpayer corporation, appearing at pages 94–96 and 110–111 of the record. This testimony is obviously of such a confused character as to give no clear picture of the debtor's true condition. Nothing so certain as a balance sheet of the debtor is offered and analyzed. The witness admitted that collateral was held consisting of a $25,000 note of another corporation and $37,000 face amount of the other corporation's stock. It was the Board's function to appraise the testimony of this witness and its judgment that such testimony did not sustain the burden upon taxpayer is binding upon the appellate court. *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, 294–295.

Two patent defects appear in the taxpayer's case for a deduction of partial worthlessness of bonds of Kentucky Fuel & Gas Corporation. First, cost was shown only by entries upon the taxpayer's books dated at the end of each year. (R. 127, 170.) The inaccuracy of those books fully appears from that portion of the Board's opinion (R. 54–67) which relates to what we call third issue (discussed *infra* under Point III). The Board was entirely justified in rejecting those book entries in the absence of some substantiating evidence concerning the transactions by which the bonds were acquired and the prices paid for them. Second, the testimony of the accountant, upon which the taxpayer must rely for the claimed deduction, clearly shows that the partial worthlessness claimed had occurred and was ascertained in a prior year. The bonds dropped from a bid price of $74 in 1930 to $5 in 1931, $1.25 in 1932, $2 in 1933, and $4.50 in 1934 (the year in which deduction was claimed). (R. 127–128.)

II

The Board correctly determined that the donee's basis for property which was the subject of two consecutive gifts was the cost to the first donor

The dispute here has to do solely with $^{20}/_{100}$ interest in the steamship Idaho, which was given by Henry Wilson to his wife on February 16, 1917, and in turn transferred by her to the taxpayer corporation (which was owned by her two sons) in 1929. The question is what basis to assign to the property in taxpayer's hands for depreciation purposes.

The transfer by Mary Wilson to taxpayer corporation amounted either to a gift to the corporation or a gift to F. A. and W. T. Wilson, Mary's sons, and capital contributions by them to taxpayer. If the latter, the capital contributions were tax-free when made. Cf. Treasury Regulations 74, Article 67, Appendix B, *infra.* Consequently taxpayer's basis for the purposes of depreciation computations in 1932, 1933 and 1934, the years here involved, is the basis (with adjustments) of the property in the hands of the Wilson brothers, transferors to the corporation. Revenue Acts of 1932 and 1934, Section 113 (a) (8), 113 (b), and 114 (a), Appendix B, *infra.* Since the Wilson brothers obtained the contributed property by gift in 1929, their basis is to be determined by Section 113 (a) (2) of the Revenue Act of 1928, c. 852, 45 Stat. 791, the pertinent portion of which is unchanged in Section 113 (a) (2) of the Revenue Acts of 1932 and 1934, Appendix B, *infra.*

On the other hand, if the 1929 transfer by Mary Wilson to taxpayer corporation was a gift directly to taxpayer, then its basis must be determined by Section 113 (a) (2) of the Revenue Acts of 1932 and 1934, Appendix B, *infra.*[4]

Thus either analysis leads to the same basic statutory provision (appearing in Section 113 (a) (2) of the 1928, 1932 and 1934 Acts.) That provision is:

> If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.

The obvious purport of this provision is as follows: If the property is purchased by A and given to B, B shall take A's cost (with adjustments) as his basis; and if property is purchased by A, who gives it to B, who gives it to C, C shall take A's cost (with adjustments) as his basis.

Section 113 (a) (4) of the 1928, 1932 and 1934 Acts provides that property given before 1921 shall have a basis in the donee's hands equal to its fair market value at the time of the gift. Taxpayer argues that where A gives to B before 1921 and B gives to C after 1921, C should take B's basis (value of the property when given to B) instead of cost to A. Such a result ignores the fact that Section 113 (a) (4) has no bearing upon C's basis, which must be determined by Section 113 (a) (2). Such a result would violate the express mandate of the words "the basis shall be the same as it would be in the hands of * * * the last preced-

[4] Point 3 of taxpayer's brief (pp. 27–32) is in error in looking to an earlier statute to determine basis in taxpayer's hands for the purpose of the years 1932, 1933, and 1934.

ing owner by whom it was not acquired by gift" used in Section 113 (a) (2). We believe no further argument is required to demonstrate that the taxpayer's position is wholly untenable.

Taxpayer hints at unconstitutionality, charging a retroactive application of the statute. This charge is based upon the fact that the first of the sequence of two gifts was made prior to 1921, when the above-quoted provisions first appeared in the tax laws (as Section 202 (a) (2) of the Revenue Act of 1921, c. 136, 42 Stat. 227). This is not significant. When the 1929 gift was made by Mary Wilson, the quoted provision was in effect and both donor and donee were upon notice of the basis which the donee would be required to take. Furthermore, Congress could, if it chose, have taxed the entire amount of a gift as income to the donee, either when received or when converted into cash. Donating property costs the donee nothing. Thus, the quoted statutory provision merely provides a method for alleviating the hardship which would result to the donee from assigning a zero basis to gift property. The taxpayer cannot complain about the mechanics employed by Congress in fixing that basis so as to prevent the accrual of tax-free increments of value. *Helvering* v. *Campbell,* decided by the Supreme Court March 31, 1941, not officially reported but found in 1941 C. C. H., Vol. 4, par. 9359; *Helvering* v. *Reynolds,* decided by the Supreme Court May 26, 1941, not officially reported but found in 1941 C. C. H., Vol. 4, par. 9484.

III

The Board's determination that taxpayer corporation was availed of in the years 1932, 1933 and 1934 to avoid surtax upon its shareholders is supported by substantial evidence

The applicable statutes are Section 104 of the Revenue Act of 1932 and Section 102 of the Revenue Act of 1934 (Appendix C, *infra*). They provide, in effect, that the income of a corporation (including dividends received by it) shall be subject to a surtax if the corporation was formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of permitting gains and profits to accumulate instead of being distributed. Each statute provides that if a corporation is a mere holding or investment company, or if its gains or profits are permitted to accumulate beyond its reasonable business needs, either of those facts shall be *prima facie* evidence of a purpose to avoid surtax.

In the instant case the Board found that the taxpayer corporation, though not formed to avoid surtax to its shareholders, was availed of for that purpose in each of the years 1932, 1933 and 1934. That determination, and the subsidiary determinations that the corporation was primarily a mere holding or investment company and that its gains or profits were accumulated beyond its reasonable business needs, are determinations which must be affirmed if supported by any substantial evidence; also, since the burden of proof was on the taxpayer, they may be supported by the presumption of correctness of the Commissioner's determination in the absence of adequate rebutting evidence. *Helvering* v.

Nat. Grocery Co., 304 U. S. 282; *Perry & Co.* v. *Commissioner* (C. C. A. 9th), decided May 23, 1941, not officially reported but found in 1941 C. C. H., Vol. 4, par. 9492; *Commissioner* v. *Cecil B. de Mille Productions,* 90 F. (2d) 12 (C. C. A. 9th), certiorari denied, 302 U. S. 713; *R. L. Blaffer & Co.* v. *Commissioner,* 103 F. (2d) 487 (C. C. A. 5th), certiorari denied, 308 U. S. 576; *Almours Securities* v. *Commissioner,* 91 F. (2d) 427 (C. C. A. 5th); *A. D. Saenger, Inc.* v. *Commissioner,* 84 F. (2d) 23 (C. C. A. 5th).

We take the liberty of reproducing for the Court the Rule 50 recomputation made pursuant to the Board's opinion and approved by the Board of the net income of taxpayer corporation and dividends received by the taxpayer in each of the years 1932, 1933 and 1934 (not in the record):

Year	Net income exclusive of dividends	Dividends	Total
1932	($11, 624. 33)	$18, 258. 00	$6, 633. 67
1933	10, 908. 61	17, 541. 00	28, 449. 61
1934	13, 905. 79	25, 057. 00	38, 962. 79

The foregoing figures compare with the following reported in the taxpayer's returns for the indicated years (R. 132–156):

Year	Net income exclusive of dividends	Dividends	Total
1932	($11, 740. 89)	$18, 258. 00	$6, 517. 11
1933	(118. 75)	17, 541. 00	17, 422. 25
1934	(1, 341. 36)	25, 057. 00	23, 715. 64

The returns of taxpayer's stockholders, W. T. Wilson and F. A. Wilson, are not in the record. From oral testimony the Board found that neither paid any income tax in the tax years in question except that W. T. Wilson paid about $150 tax in 1932. (R. 59.) Taxpayer seeks to attach significance to the fact that the Commissioner failed to produce the returns of these individuals. (Br. 56.) The burden of proof being upon the taxpayer, any unfavorable inference from failure to produce those returns must redound against the taxpayer rather than the Commissioner. Consequently, for the purposes of this analysis, we are entitled to assume that in each of the years when no tax was paid by individual stockholders, the addition of a single dollar to the income of either would have resulted in tax.

It is apparent that for the years 1933 and 1934 a distribution of taxpayer's earnings would have placed the income of both shareholders in surtax brackets, whether the earnings found by the Board or those reported in taxpayer's returns are used. In 1933 surtaxes started with $6,000 net income and in 1934 with $4,000 net income. Revenue Acts of 1932 and 1934, Section 12. The difference between the two statutes is compensated for, however, by the fact that in computing income subject to surtax, credits for personal exemption and dependents (Sec. 25) are not allowed under the 1932 Act, whereas they are allowed under the 1934 Act. Thus, under either statute we are entitled to assume that a distribution of about $4,000 from the taxpayer corporation to each of its two shareholders would have brought the income of each shareholder into the surtax brackets. The income available for distribution was considerably in excess of $4,000 for each of the two shareholders.

In 1932 it may be assumed, perhaps, that a distribution of earnings would not have resulted in surtax to F. A. Wilson. But it certainly would have put the income of W. T. Wilson into the surtax brackets, for he paid a tax of $150, indicating an income over and above personal exemption and credit for dependents of approximately $3,750. Adding to this amount $3,000 from the taxpayer and an exemption and credit for dependents of, say, $3,000 would give him an income of about $10,000, well within the surtax area.

It cannot be denied, therefore, that surtaxes to the individual shareholders of taxpayer were avoided by not distributing to them the earnings of taxpayer which accumulated in each of the tax years in question. The fact that the surtaxes avoided were small is certainly not conclusive of no purpose to avoid surtax. Equally inconclusive is the fact that in one of the years only one of the two shareholders was saved from surtax by taxpayer's retention of its earnings.

An argument is made (Br. 42–44) that the earnings available for distribution should be deemed reduced by a shrinkage in value of assets such as securities, notes, and accounts receivable. The Board found that taxpayer owned securities in the following amounts in each of the years in question (R. 58):

Year	Market value	Cost
1932	Approximately $440,000	$751,000
1933	" 778,000	782,000
1934	" 810,000	838,000

It is readily apparent that considerable fluctuation in value of such a large block of securities is inevitable and is not material to the issue whether the income from those securities has been withheld from distribution to the shareholders for the purpose of saving them surtaxes. That it is not material has been established by authoritative decisions. *Helvering* v. *Nat. Grocery Co., supra; A. D. Saenger, Inc.* v. *Commissioner, supra.* It is even more readily apparent that that issue is not affected by the fact that taxpayer may have thought certain accounts receivable among its assets were partially worthless, or that certain bonds had declined in value below their cost to the taxpayer. See taxpayer's [illegible]

·tially worthless debts, and
real unnecessarily accumulated

[illegible] of the years in question

It handled only the following gross lumber business (R. 56, 58):

Year	Gross sales	Cash and securities on hand
1932	$28, 725. 96	Approximately $536,000.
1933	92, 262. 09	" 787,000.
1934	170, 239. 51	" 884,000.

It is also significant that the business carried on by taxpayer made no profit in any of the three years and that the income which accrued and was accumulated in each year resulted from dividends upon its investments in securities. We do not believe that a reasonable argument could be made to the effect that the very large accumulation of cash and securities available to the taxpayer was necessary to carry on the business which it did in the tax years in question.

Taxpayer's principal claim (Br. 32–61) is that it contemplated a renewal of operations on a very much larger scale, including the operation of its boats and the carrying on of milling and logging business. It points to the testimony of one of its two stockholders that for such a business a capital of $1,500,000 was required.

The Board rightfully deemed that the testimony of taxpayer's shareholder concerning the purpose to expand and the amount of capital which would be required, was inadequate to sustain the burden upon the taxpayer. This testimony appears at pages 101 *et seq.* of the record. It is of a vague and general character. No details of the expansion contemplated are given. No time for the expansion is set or estimated. Though the reason for the restricted business in the tax years was said to be the business depression, there is no testimony that the expansion had occurred at any time prior to the trial in 1939; it is common knowledge that a business recovery had occurred before that time. The testimony concerning the need for capital of $1,500,000 related to the time of the trial. No estimate was made for the capital which would have been necessary to resume the full business in the tax years or immediately thereafter.

In addition to the vagueness of the testimony, the Board was reluctant to give it full credence because of the many inconsistencies in the sworn statements of the witness and his brother. (R. 62–67.) The weight and credibility of interested testimony of this type is for the Board to determine. If it had so chosen, the Board could have disregarded this testimony altogether. *Helvering* v. *Nat. Grocery Co., supra,* at pp. 494–495.

From the whole record, it was reasonable to infer that in the years 1932 to 1934, inclusive, taxpayer had no such immediate intention to greatly expand as would require the accumulation of securities income on top of the securities and cash already held. It was reasonable to infer that taxpayer was to be used primarily as a holding or investment company, not only in the tax years, as the Board found, but in subsequent years as well. Its large investments in bonds and stocks were accumulated to a great extent out of contributions to the capital of the corporation by its two shareholders. Cf. *Helvering* v. *Nat. Grocery Co., supra; Perry & Co.* v. *Commissioner, supra; R. L. Blaffer & Co.* v. *Commissioner, supra.* It was rather obviously the incorporated pocketbook of the Wilson family. Cf. *R. L. Blaffer & Co.* v. *Commissioner, supra; Almours Securities* v. *Commissioner, supra; A. D. Saenger, Inc.* v. *Commissioner, supra.* The existence of large accounts receivable from its two shareholders in each of the years in question is indicative that the accumulations of earnings were not necessary for working capital. Cf. *Helvering* v. *Nat. Grocery Co., supra; Perry & Co.* v. *Commissioner, supra; A. D. Saenger, Inc.* v. *Commissioner, supra; United Business Corp.* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), certiorari denied, 290 U. S. 635.

Typical of the taxpayer's protest against the Board's findings is its statement (Br. 53) that there is not a shred of evidence to support the Board's conclusion that accounts receivable from "W. Wilson" shown on the books were accounts receivable from W. T. Wilson, half owner and treasurer of the taxpayer corporation. Taxpayer, who bore the burden of proof, has not suggested who else "W. Wilson" might be or made any reasonable explanation for loans to some other party than W. T. Wilson.

We submit that there is ample evidence to sustain the Board's determination that taxpayer was primarily a holding or investment company, that earnings were accumulated beyond the reasonable needs of its business, and that it was availed of to avoid surtaxes to its stockholders in the tax years in question.

IV

The Board's imposition of the negligence penalty should be sustained

While the specific items of negligence and resulting deficiency giving rise to the penalty were not recited by the Board, we believe there is substantial evidence to support the Board's conclusions that some part of the deficiency flowed from the taxpayer's negligence. Under the statute, the penalty falls upon the entire deficiency if any part of it is due to negligence. Revenue Acts of 1932 and 1934, Section 293 (a), Appendix D, *infra*.

The negligence penalty certainly is warranted if the taxpayer takes deductions the improper size or character of which would have been revealed by careful bookkeeping or a reasonably careful analysis of the statutes and regulations. We believe the penalty to be warranted when a deduction is taken, though its propriety can be neither proved nor disproved because of carelessly incomplete records. It is a fair inference from this record that at least some of the deductions disallowed by the Board resulted from careless or incomplete bookkeeping or a failure to make a reasonably careful attempt to follow the law and Treasury rules.

V

The form of the Board's memorandum opinion reveals no error

The Board was not required to make separate fact findings and separately state conclusions of law. No form for a memorandum opinion is specified by statute. Internal Revenue Code, Section 1117 (b), Appendix E, *infra. California Iron Yards Co.* v. *Commissioner,* 47 F. (2d) 514, 518 (C. C. A. 9th); *Insurance & Title Guarantee Co.* v. *Commissioner,* 36 F. (2d) 842 (C. C. A. 2d), certiorari denied, 281 U. S. 748; *Emerald Oil Co.* v. *Commissioner,* 72 F. (2d) 681 (C. C. A. 10th). The Board's separate grouping of the facts and discussion pertaining to each issue is, to say the least, helpful to a clear consideration of this case. It is hard to see how this wise arrangement can seriously be criticized, though taxpayer has undertaken to do so. We think taxpayer unwarranted in inferring that the Board, in discussing each issue, closed its mind to the facts and circumstances recited in connection with other issues.

The fair assumption is, we think, that the facts primarily concerning each issue were analyzed by the Board against the background of the entire case.

CONCLUSION

The decision of the Board of Tax Appeals should be affirmed.

Respectfully submitted,

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JUNE, 1941.

APPENDIX A

STATUTE AND REGULATIONS PERTAINING TO FIRST ISSUE

Revenue Act of 1934, c. 277A, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> *   *   *   *   *
>
> (k) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.
>
> *   *   *   *   *
>
> (U. S. C., Title 26, Sec. 23.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

> ART. 23 (k)-1. *Bad debts.*—Bad debts may be treated in either of two ways—
>
> (1) By a deduction from income in respect of debts ascertained to be worthless in whole or in part, or
>
> (2) By a deduction from income of an addition to a reserve for bad debts.
>
> *   *   *   *   *
>
> If all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income.

There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

* * * * *

ART. 23. (k)–4. *Worthless bonds and similar obligations.*—Bonds, if ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year.

A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. If a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations and so demonstrates to the satisfaction of the Commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations.

APPENDIX B

STATUTES AND REGULATIONS PERTAINING TO SECOND ISSUE

Revenue Acts of 1932, c. 209, 47 Stat. 169; and 1934, c. 277, 48 Stat. 680:

The following provisions are identical in the two Acts, except that the italicized portion of Section 113 (a) (2) appears in the 1934 Act only; and of Section 114 (a) in the 1932 Act only.

> SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.
>
> (a) *Basis (Unadjusted) of property.*—The basis of property shall be the cost of such property; except that—
>
> * * * * *
>
> (2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, *except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower.* If the facts necessary to determine the basis *in the hands of the donor or the last preceding owner* are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis *in the hands of such donor or last preceding owner* shall be the fair market value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information that the

Commissioner is able to obtain, such property was acquired by such donor or last preceding owner.

*   *   *   *   *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

*   *   *   *   *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *

* * * * *

(U. S. C., Title 26, Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property.

* * * * *

(U. S. C., Title 26, Sec. 114.)

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

> ART. 67. *Contributions to corporation by shareholders.*—Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments in such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. (See articles 64 and 282.)

APPENDIX C

STATUTES AND REGULATIONS PERTAINING TO THIRD ISSUE

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(1) 25 per centum of the amount of the adjusted net income not in excess of $100,000, plus

(2) 35 per centum of the amount of the adjusted net income in excess of $100,000.

(b) *Prima Facie Evidence.*—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to avoid surtax.

(c) *Definition of "Adjusted Net Income".*—As used in this section, the term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.

(d) *Payment of Surtax on Pro Rata Shares.*—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) *Tax on Personal Holding Companies.*—For surtax on personal holding companies, see section 351. (U. S. C., Title 26, Sec. 104.)

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

Art. 541. *Taxation of corporation utilized for evasion of surtax.*—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders, through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate of 50 per cent does not apply for 1932 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a dividend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

ART. 542. *Purpose to escape surtax.*—Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

Art. 543. *Unreasonable accumulation of profits.*—An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).) [1]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 102–1. *Taxation of corporation formed or utilized for avoidance of surtax.*—Section 102 imposes a graduated income tax or surtax upon

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[1] Amendments of Articles 541, 542, and 543 of Treasury Regulations 77 were made in 1934 by T. D. 4470, XIII–2 Cum. Bull. 151, but they are not of sufficient significance to the present controversy to reproduce here.

any domestic or foreign organization formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting gains and profits to accumulate instead of dividing or distributing them. However, personal holding companies, as defined in section 351, being taxed separately in accordance with the provisions thereof, are excepted from taxation under section 102. The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation. The surtax is in addition to the taxes levied upon corporations generally by Title I. For the computation of the surtax see article 102–4.

ART. 102–2. *Purpose to avoid surtax.*—The Act provides two prima facie presumptions of the existence of a purpose to avoid surtax. The fact (1) that any corporation is a mere holding or investment company, or (2) that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, constitutes prima facie evidence of a purpose to avoid the individual surtax. A corporation having practically no activities except holding property, and collecting the income therefrom or investing therein, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102.

The assumed purpose to avoid the individual surtax is subject to disproof by competent evidence like any other question. Proof of the purpose, therefore, depends upon the particular circumstances of each case. In other words, the purpose may be evidenced by circumstances other than the presumptions specified in the Act. A corporation is subject to taxation under section 102 when it is formed or availed of for the purpose of preventing the imposition of the individual surtax regardless of whether it is a mere holding or investment company, or whether the accumulations, if any, are in excess of the business needs. On the other hand, the statutory presumptions will be overcome if the corporation can show, by a disclosure of all the facts, that it was neither formed nor availed of for the purpose of avoiding the individual surtax, but the mere fact that it distributed a large portion of its earnings for the year in question is not sufficient to overcome the presumption. All the circumstances which might be construed as evidence of the purpose can not be outlined. Among other things the following will be taken into consideration in determining the existence of such purpose: (1) Dealings between the corporation and its shareholders such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business.

Art. 102-3. *Unreasonable accumulation of profits.*—An accumulation of gains and profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business.

The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)

APPENDIX D

STATUTES PERTAINING TO FOURTH ISSUE

Revenue Acts of 1932, c. 209, 47 Stat. 169; and 1934, c. 277, 48 Stat. 680:

> SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.
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> (a) *Negligence.*—If any part of any deficiency due to negligence, or intentional disregard of rules and regulations but without intent to defraud, 5 per centum of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected, and paid in the same manner as if it were a deficiency, except that the provisions of section 272 (i), relating to the prorating of a deficiency, and of section 292, relating to interest on deficiencies, shall not be applicable.
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> (U. S. C., Title 26, Sec. 293.)

APPENDIX E

Internal Revenue Code:

SEC. 1117. REPORTS AND DECISIONS.

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(U. S. C., Title 26, Sec. 293.)

(b) *Inclusion of Findings of Fact or Opinions in Report.*—It shall be the duty of the Board and of each division to include in its report upon any proceeding its findings of fact or opinion or memorandum opinion. The Board shall report in writing all its findings of fact, opinions and memorandum opinions.

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